Press Release

RBI-MPC: Balance set to tilt towards growth

Challenging times for the central bank with sticky headline inflation, stronger dollar and slowing GDP growth

December 4, 2024

As the Reserve Bank of India's (RBI) Monetary Policy Committee (MPC) convenes for its meeting, the economic outlook is marked by uncertainty on growth and a caution on the inflationary front. RBI's Governor and the six-member panel are tasked with a difficult balancing act, which should keep the inflation "elephant away in the forest" while mitigating the risks of a sustained slowdown.

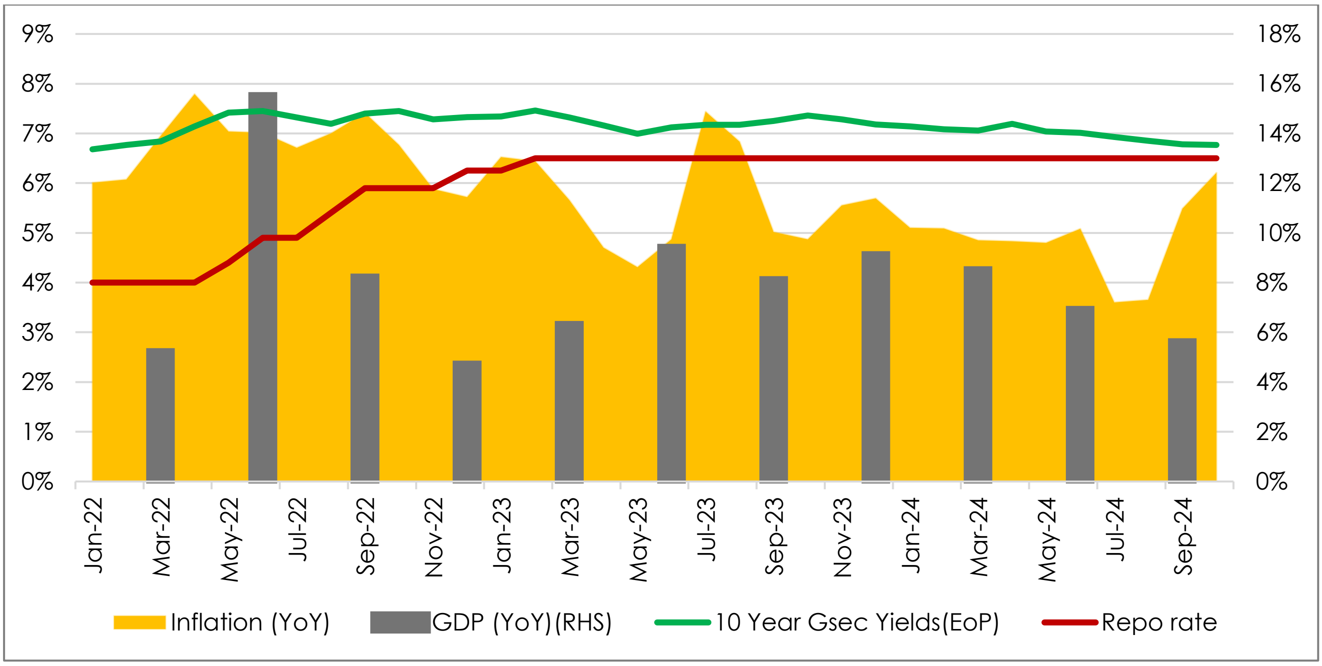
India's economic growth has shown clear signs of strain. The Q2 FY25 GDP growth rate slumped to 5.4%, a sharp deviation from the projected 6.5% and marking the slowest growth in seven quarters. This slowdown follows a post-pandemic recovery that showed significant resilience for around 3 years. The manufacturing sector, which had been a driving force of India's recovery, has hit a significant roadblock. In Q2 FY25, manufacturing grew by just 2.2%, a sharp contrast to the 14.3% growth recorded in the same period last year. This reflects a series of compounding challenges: weaker urban demand, a slowdown in exports due to global economic conditions, and a stronger dollar, which has driven up input costs for businesses. However, there are also reasons to be optimistic on other fronts. The agricultural sector, which had been sluggish in the previous fiscal year, has started to rebound amidst a favourable monsoon. The sector grew by 3.5% in Q2FY25, offering a much-needed lifeline for rural India. This sector's recovery is expected to bolster the rural economy in the current fiscal, providing a boost to private consumption. While the economic slowdown is difficult to deny, there are indications that the worst may be over. With signs glowing red and green together, the outlook could improve in the second half of the fiscal year. The festival and wedding season is expected to boost urban demand in Q3, offering a temporary reprieve for sectors facing weaker consumption. Nevertheless, in lieu of the latest print, we have downgraded our growth forecasts to 6.4% for FY25. We will await RBI's commentary on the growth scenario given its earlier optimism; it continued to peg its growth forecast for FY25 at 7.2% till Oct-24; the extent of the downward growth revision will be an important indicator of the speed of transition from hawkishness to dovishness.

The central bank faces a choice: whether to maintain the status quo on interest rates and expect inflation to be reined in or take proactive action to support economic growth. So far, the RBI has kept the repo rate steady at 6.5% for the last nine policy meetings. The status quo reflects the RBI's cautious approach, especially amidst stubborn food inflation levels of over 8%. Headline CPI inflation remains a significant concern, clocking in at 6.21% in October, well above the RBI's target range. This rise exceeded market expectations, which had anticipated a more moderate increase to around 5.8%. Food and beverages inflation reached a 15-month high of 9.7%, with significant increases in the prices of vegetables, edible oils, and cereals and importantly, a concern that the seasonal downward trajectory in such prices may be slow and delayed.

The RBI is expected to keep its repo rate steady in Dec-24 amidst such concerns on the inflation front and also amidst capital outflows, stronger dollar and weaker rupee. We expect the inflation to moderate in Q4 FY25 and there are risks that growth will be slower than currently envisaged i.e. 7% in H2FY25. This should prompt RBI to ease rates in February, signalling a more accommodative stance as it navigates the delicate task of managing India's economic growth in uncertain global and domestic conditions.

The global environment is becoming increasingly challenging, with markets preparing for a stronger dollar, higher capital costs, and significant investment flows back to the US, limiting the options for RBI if growth was to slow down significantly. This may persuade the central bank to consider non-rate measures; a Cash Reserve Ratio (CRR) cut may be on the table. A CRR cut would inject liquidity into the banking system, providing a cushion for economic activity without directly affecting the repo rate. Between Dec-24 and Feb-25, there is a significant likelihood of a 50-bps cut in CRR, bringing it to 4.00% from 4.50%.

Chart 1: Growth, Inflation, Repo rate, G-sec yields



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